

Formal Action # 15189

IN THE CHANCERY COURT OF TENNESSEE, KNOX COUNTY
SIXTH JUDICIAL DISTRICT AT KNOXVILLE

STATE OF TENNESSEE,
Plaintiff,

v.

STRATEGIC TELECOM SYSTEMS,
INC., a Tennessee corporation, and
Anthony R. Catinella, Individually, and as
President and Director of Strategic Telecom
Systems, Inc.,
Defendants.

FIRST AMENDED COMPLAINT

John Knox Walkup, Attorney General and Reporter ("Attorney General"), brings this civil action in the name of the State of Tennessee under Tenn. Code Ann. §§ 47-18-108(a)(1) and 47-18-114, at the request of the Division of Consumer Affairs of the Tennessee Department of Commerce and Insurance (the "Division"), having reason to believe that the Defendants, Strategic Telecom Systems, Inc. ("STS" or the "Company") and Anthony R. Catinella ("Catinella"), have violated the Tennessee Consumer Protection Act of 1977, Tenn. Code Ann. §§ 47-18-101 et seq., and other applicable law.

JURISDICTION AND VENUE

1. Plaintiff invokes this Court's jurisdiction under Tenn. Code Ann. § 47-18-108 and other applicable law. Venue is proper in Knox County, according to the provisions of Tenn. Code Ann. § 47-18-108(a)(3), because it is a county in which Defendants have conducted business. Specifically, the headquarters of the corporate Defendant is located in Knox County. Further, Plaintiff provided STS with ten days notice of the Attorney General's intention to file this action consistent with Tenn. Code Ann. § 47-18-101(a)(2). The State has also separately notified Catinella of its intention to file suit against him individually and as an officer and director of the corporation in accordance with Tenn. Code Ann. § 47-18-101(a)(2). See, Affidavit and Verification of Mark Williams, Director, Division of Consumer Affairs, Department of Commerce and Insurance, which is attached to this First Amended Complaint as Exhibit A. Plaintiff alleges that Defendants have engaged in unfair and deceptive acts or practices in the conduct of trade or commerce in part or wholly within this State. Tenn. Code Ann. § 47-18-102(2). Further, Defendants developed a network of independent representatives who reside in Tennessee and other states. Plaintiff, further, invokes this Court's jurisdiction over Defendants to enjoin them to "restore to any person who suffered any ascertainable loss ..." money Defendants "acquired" as a result of Defendants' unlawful acts or practices, regardless of whether those persons reside in Tennessee or in other states. Tenn. Code Ann. § 47-18-108(b)(1).

PARTIES

2. John Knox Walkup, the Attorney General and Reporter, at the request of the Director of the Division of Consumer Affairs, brings this action in the name of the State of Tennessee under Tenn. Code Ann. §§ 47-18-108(a)(1) and 47-18-114, and pursuant to his common law authority.

3. STS is a Tennessee corporation. Its principal place of business is 6420 Baum Drive, Knoxville, Tennessee 37901.

4. Catinella is a resident of Knox County, Tennessee. His residence is located at 4615 River Oak Drive, Knoxville, Tennessee. Catinella is sued individually because he participated directly in the acts and practices which make STS liable and, further, because he had knowledge of the practices and authority to stop them. Additionally, Catinella is sued in his individual capacity because in 1996 and 1997 he caused over a million dollars in STS funds to be paid to himself and others, through a variety of entities, which should be made available to satisfy claims against STS. This conduct was contrary to Catinella's representations in a sworn statement given to representatives of the State of Tennessee in August 1996 that he was being paid \$240,000.00 per year.

FACTUAL ALLEGATIONS

5. STS was formed and began operating in May 1995. The company sells telecommunications products, primarily pre-paid long distance telephone calling cards, through a multi-level marketing plan featuring "wholesale" sales to its sales agents or independent representatives (hereafter "representatives" or "participants"). STS and Catinella have continuously engaged in the conduct alleged in this First Amended Complaint since 1985 from their headquarters in Knoxville, Tennessee.

6. The majority of STS revenues come from representatives recruiting new participants to join STS. New recruits must complete a one-page application and contract, and pay \$99 for a "Career Manual", videotapes and sales literature. In order to earn "commissions," representatives must produce products, typically prepaid long distance telephone calling cards. Products must usually be purchased in \$200 or \$600 increments. Once a representative has purchased the required amount of a product, the representative earns further "commissions" by recruiting new representatives who are, in turn, required to buy a certain amount of products from STS. Attached as Exhibit B is a representative copy of STS' Independent Representative Agreement.

7. Catinella was one of three original directors and founders of STS. From its inception, he served as the company's president and participated in the formation and operation of the multi-level marketing program described herein. Catinella was instrumental in designing, promoting and implementing STS's multi-level marketing scheme and in STS persisting in the substance of STS's plan after several states, including Tennessee, raised legal questions about it beginning in early 1996, such as whether the STS plan constituted an unlawful pyramid scheme which would likely collapse and cause substantial losses to its participants. Despite these warnings, STS and Catinella took no meaningful precautions to protect its participants, but, rather, Catinella began to take large sums of STS funds out of STS through various entities.

8. Through a massive national campaign, STS built a multi-level marketing network of approximately 200,000 representatives by mid-1997. Because of STS's business practices and prevailing economic realities, STS is no longer accepting new participant agreements or product orders and the multi-level plan has, for all practical purposes, collapsed.

9. STS represents to potential new recruits that it will sell them prepaid telephone cards at "wholesale" prices. STS claims that by using STS calling cards STS customers can save up to 60% on long distance charges. In fact, the "wholesale" price at which STS sells prepaid long distance cards exceeds competitive retail market prices. In 1996, according to STS's literature, STS was charging up to \$.74 per minute, "wholesale" price, for the initial purchase (by representatives) of its prepaid calling cards. Retail rates for competitors were as low as \$.20 per minute and the State of Tennessee has not discovered any retail rates which exceed \$.74 per minute.

10. STS also represents to potential new recruits that the prepaid telephone cards are easily sold at retail for a profit. STS does not have a reasonable basis for this claim, and cannot substantiate that there is a large retail market for its prepaid telephone cards. STS does not maintain any documentation of retail sales in the ordinary course of business and has not shown the State of Tennessee proof to substantiate a claim that even one of its representatives made a sustained profit from making retail sales.

11. When a representative orders products from STS, the products are paid for at the time the order is placed. STS has charged buyers' credit accounts prior to shipment of ordered products, failed to provide shipment delay notices, and failed to honor cancellations prior to shipment of ordered products, failed to provide shipment delay notices, and failed to honor cancellation notices in violation of the Federal Trade Commission Mail Order Rule, 16 CFR 255.

12. Upon joining STS, representatives were assigned a place in the company's computer called an "Income Resource Center". This Income Resource Center is basically a tracking mechanism which enabled the company and representatives to calculate "commissions" and track STS's participant genealogy.

13. Apart from STS's claim that representatives could sell STS long distance cards at retail for a profit, the other income generating alternative offered by STS allowed independent representatives, after purchasing an "income resource center," to develop their sales organization by recruiting others into their "down lines" and by continuing to purchase products at "wholesale" prices from STS. This is the only method by which independent representatives could receive "commissions" from STS. Representatives did not receive "commissions" on retail sales.

14. The STS multi-level network is a "binary" scheme. Attached as Exhibit C is a page from the STS "career manual" which illustrates the binary plan. This means that each representative can only sponsor two recruits into his/her immediate downline. Under the STS plan, however, commissions are paid on a "sales organization" of at least thirty levels, which according to STS literature, means a representative may be paid on the "wholesale" sales volume of up to 2.1 billion "income resource centers." When two representatives are recruited, the sponsoring representative qualifies, at least initially, to receive commissions based on his/her down lines' wholesale purchases from STS. Additionally, because commissions are based solely on recruiting and wholesale orders from STS, participants can and, in fact, did receive commissions without making a single retail sale and without training anyone in his/her downline how to earn commissions through retail sales. In short, the retail sale portion of STS's multi-level plan, is illusory and without substantial economic reality.

15. After STS entered into settlements with the states of Michigan, Florida, Mississippi, Alabama, Kansas, Pennsylvania, Wisconsin, and North Dakota relating to various aspects of the STS program, STS began performing a 2% random sampling of its independent representatives to determine if retail sales were being made. Prior to this development, STS had absolutely no procedure to verify retail sales by its representatives. In fact, in May 1997, one of the officers of STS, Bert Schlegel, told a representative who lives in Florida that he was wasting his time trying to make retail sales because STS was about recruiting new participants.

16. The sole corporate signatory are the settlement agreements with the states listed in paragraph 15 was Defendant Catinella.

17. STS' product stock has been depleted and the company is no longer distributing products for resale. However, as mentioned in paragraph 9, above, STS sold prepaid long distance cards to its independent representatives at "wholesale" prices which exceed prevailing retail market prices. STS did not disclose to its independent representatives that these "wholesale" prices for prepaid long distance telephone cards actually exceeded the prevailing retail market prices. In fact, STS promotes information to the contrary, that by using STS calling cards, consumers can save up to 60% savings off other long distance providers. Attached as Exhibits D and E are excerpts from the STS "career manual."

18. STS has also produced, distributed and sold long distance prepaid telephone cards that do not work or that expire within an unreasonably short period of time. Some cards sold by STS did not work, or were canceled, because STS failed to maintain its accounts with long distance service providers. Still other cards were forwarded to an adult entertainment line. Additionally, STS, in the fall of 1997, sold sales and promotional kits to representatives without disclosing to them that STS's multi-level plan was collapsing and that the long distance phone cards were not being honored.

19. In its promotional materials, STS states that the company's policy is to provide a 90% refund for products returned in a "resalable and reusable" condition. But STS places unreasonable restrictions upon a representative's right to receive a refund, which were not adequately disclosed to potential new recruits.

20. Hundreds of representatives who have complied with the unreasonable restrictions placed upon their right to return products for a refund have not been paid the promised refund.

21. STS misrepresents, and fails to adequately disclose, the consequences of a representative's withdrawal from STS. As a result, STS has manipulated and withheld payment of commissions and refunds, and has retained thousands of dollars owed to its participants. Despite the failure to pay refunds and commissions, STS through Defendant Catinella, engaged in a practice of moving money from STS accounts to other entities owned and/or operated by Catinella. Catinella, moreover, is planning to start another multi-level marketing company in another state or country while simultaneously causing STS to represent to this Court and to other tribunals that STS is financially unable to pay refunds to representatives.

22. In order to continuously develop multiple levels of representatives, STS preempted expected resistance from potential participants. To that end, the company, through its active participants, created an impression of easy money requiring little or no work. To establish and maintain this impression STS:

a) Made or condoned unsubstantiated earnings claims by, at a minimum, displaying copies of commission checks;

b) Encouraged independent representatives to focus on recruiting new independent representatives because STS does not pay any "commissions" based on retail sales;

c) Encouraged independent representatives to not make retail sales and implicitly, to falsely report that 70% of their previous wholesale orders have been sold, at retail, to end user consumers;

d) Circulated or condoned the use of videotapes and potentially other marketing tools, which encourage independent representatives to engage in the conduct alleged in paragraph 15(a),(b) and (c), above; and

e) Encouraged the recruitment of, and accepted applications from, virtually any potential

participant regardless of his/her age, background, experience or ability.

23. When this suit was originally filed, on December 9, 1997, consumers had submitted approximately twelve hundred complaints against STS with Tennessee Department of Commerce and Insurance, Division of Consumer Affairs. As of March 15, 1998, over eighteen hundred complaints have been submitted to the Division. For the most part, those complaints fall into the following categories:

(A) The STS telephone cards do not operate properly;

(B) STS does not respond to representatives' requests for customer service and complaint resolution, and/or for customer service; and

(C) STS has not made refunds to independent representatives. STS has resolved some of these complaints; many complaints, however remain unresolved.

24. STS represents to potential new recruits that it will provide superior customer service, training, and support to its Independent Representatives. But STS has failed even to reasonably address the communications, complaints, customer service needs, inquiries, and requests of its representatives. Before STS's multi-level marketing scheme collapsed in the fall of 1997, STS did not maintain a sufficient phone system for representatives to call them and was often unresponsive to faxes and other communications from representatives. Beginning in the fall of 1997, moreover, STS began to send back complaints unopened and to be even more unresponsive to complaints and inquiries from representatives.

25. STS uses and employs a chain referral sales plan in connection with the sale of its products through which buyers and prospective buyers are offered the opportunity to purchase goods or services and, in connection with the purchase, receive the seller's promise or representation that the buyer shall have the right to receive compensation or consideration for furnishing to the seller the names of other prospective buyers. The receipt of compensation or consideration is contingent upon the occurrence of events subsequent to the time the buyer purchases STS merchandise or goods.

26. STS sells and offers to sell to new recruits the right to participate in a pyramid distributorship.

27. Representatives' commissions are based solely on recruiting and wholesale orders from STS. Therefore, Independent Representatives can and do receive commissions without ever making a retail sale of any product produced or marketed by STS.

28. As a result of Defendants' actions as described herein, consumers have suffered losses of money and/or property and additional consumers may continue to suffer losses.

29. Defendants' activities in offering for sale a multi-level marketing program, franchise or business opportunity in this State and the sale of pre-paid calling cards constitute "trade" or "commerce" and the offering of or providing of "goods" as defined in Tenn. Code Ann. § 47-18-103(5) and (9).

30. The Defendants' conduct violates the stated purposes of the Tennessee Consumer Protection Act stated at Tenn. Code Ann. § 47-18-102 which provides, in pertinent part:

The provisions of this part shall be liberally construed to promote the following practices:

(1) To protect consumers and legitimate business enterprises from those who engage in unfair or deceptive acts or practices in the conduct of any trade or commerce in part or wholly within this state;

(2) To declare and to provide for civil legal means for maintaining ethical standards of dealing between persons engaged in business and the consumer public to the end that good faith dealings between buyers and sellers at all levels of commerce be had in this state....

VIOLATIONS OF THE LAW

For each of the following Counts, Plaintiff realleges Paragraphs 1 through 30:

COUNT I

31. By misrepresenting the market value of STS prepaid telephone cards, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), 104(b)(7), and 104(b)(27).

COUNT II

32. By misrepresenting the potential and expected earnings of new STS representatives, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), and 104(b)(27).

COUNT III

33. By taking orders for STS products and (1) charging buyers before the products are shipped, (2) failing to provide shipment delay notices, and (3) failing to honor cancellation notices, Defendants have violated the Federal Trade Commission Mail Order Rule, 16 CFR 255, and Tenn. Code Ann. §§ 47-18-104(a), 104(b)(12), and 104(b)(27).

COUNT IV

34. By selling products that do not work or that expire within an unreasonably short period of time, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), 104(b)(7), and 104(b)(27).

COUNT V

35. By misrepresenting and violating its refund policy, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), 104(b)(12), and 104(b)(27).

36. By misrepresenting and misapplying the penalties for withdrawing from STS, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), 104(b)(12), and 104(b)(27).

COUNT VI

37. By misrepresenting the extent to which it would address the communications, complaints, customer service needs, inquiries and requests of independent representatives, Defendants have violated Tenn. Code Ann. § 47-18-104 (a), 104 (b)(5), 104 (b)(12), and 104 (b)(27).

COUNT VII

38. By employing an illegal chain referral sales plan, Defendants have violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(18), and 104(b)(27).

COUNT VIII

39. By selling and offering to sell the right to participate in a pyramid distributorship, Defendant has violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(20), and 104(b)(27).

COUNT IX

40. For this count, Plaintiff realleges Counts I - VIII. By inflicting substantial unjustified consumer injury, Defendants have engaged in unfair acts and practices and violated Tenn. Code Ann. § 47-18-104(a).

COUNT X

41. For this count, Plaintiff realleges Counts I - IX. By participating directly in the acts and practices of STS which make STS liable, by having knowledge of STS's practices and not exercising his authority to stop them and by transferring STS funds to himself and others through other entities, Cantinella, individually, has violated Tenn. Code Ann. §§ 47-18-104(a), 104(b)(5), 104(b)(7), 104(b)(12), 104(b)(18), 104(b)(20), and 104(b)(27).

DEMAND FOR RELIEF

WHEREFORE, PREMISES CONSIDERED, THE STATE OF TENNESSEE PRAYS:

(1) That this Complaint be filed without cost bond as provided by Tenn. Code Ann. §§ 20-13-101, 47-18-108 and 47-18-116.

- (2) That process issue and be served upon STS and Cantinella pursuant to Tenn. Code Ann. § 20-2-201, requiring it to appear and answer this Complaint.
- (3) That this Honorable Court adjudge and decree that STS and Cantinella have engaged in acts or practices in violation of the Tennessee Consumer Protection Act, Tenn. Code Ann. §§ 47-18-101, et seq., as previously set forth.
- (4) That this Honorable Court permanently enjoin STS and Cantinella from directly or indirectly engaging in the unfair and deceptive practices alleged in this Complaint.
- (5) That this Court make such orders or render such judgments as may be necessary to provide full restitution including statutory interest and to otherwise restore to any person any ascertainable losses suffered by reasons of the alleged violations of the Tennessee Consumer Protection Act.
- (6) That the Court enter an injunction rescinding all contracts between STS and its representatives.
- (7) That the Court enter an injunction against STS and Cantinella requiring them to disgorge all profits generated from the unlawful scheme and plan alleged in this complaint.
- (8) That the Court appoint a Special Master to inventory STS's bank accounts, monitor STS's operations, make reports to the Court regarding the assets, obligations, liabilities, claims and financial status of STS and, if warranted, its affiliates.
- (9) That the Court, after a review of all relevant circumstances, appoint a receiver to take possession of all of STS's assets and to liquidate STS's assets, if necessary, in conformity with the orders and at the direction of the Court.
- (10) That the Court adjudge and decree that the STS and Cantinella are liable to the State for the reasonable costs and expenses of the investigation and prosecution of the STS's actions, including attorneys' fees, as is provided by Tenn. Code Ann. § 47-18-108(b).
- (11) That the Court adjudge and decree that the STS and Cantinella pay civil penalties of not more than one thousand dollars (\$1,000.00) per violation of the Tennessee Consumer Protection Act to the State as provided by Tenn. Code Ann. § 47-18-108(b).
- (12) That all costs in this cause be taxed against STS and Cantinella.
- (13) That this Court grant Plaintiff such other and further relief as this Court deems just and proper.

Respectfully submitted,

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